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C O N F I D E N T I A L SECTION 01 OF 07 TEL AVIV 001336

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E.O. 12958: DECL: 03/04/2014
TAGS: EFIN ECON ETRD BEXP IS ECONOMY AND FINANCE ISRAEL RELATIONS
SUBJECT: ISRAEL'S ECONOMIC POLICIES GET HIGH MARKS AT THE 2004 JEDG

REF: TEL AVIV 1033

Classified By: Ambassador Daniel C. Kurtzer for Reason 1.4 (B) and (D)

¶1. (C) Summary. The U.S. delegation to the 2004 U.S.-Israel Joint Economic Development Group meeting in Jerusalem (JEDG), led by Under Secretary Larson and Treasury Under Secretary Taylor, expressed satisfaction with the steps the Government of Israel has taken to implement the government's economic reform plan. The JEDG endorsed the release of the 2004 tranche of loan guarantees (up to $3 billion), noting that the GOI had met its commitments under the terms of the U.S.-Israel Loan Guarantee Agreement (LGA). Although the U.S. team praised the GOI for meeting the 2003 expenditure targets outlined in the LGA 2003 terms sheet, it urged heightened vigilance in meeting the GOI's expenditure and deficit targets in 2004.

¶2. (C) The U.S. and Israeli JEDG delegations drafted a new terms sheet detailing LGA commitments for 2005 (text in para. 19). This terms sheet will be annexed to the agreement pending approval by Minister Netanyahu. Especially notable is a commitment to meet expenditure targets in 2004 and to limit real expenditure growth to 1% per year from 2005-2010. Finance Minister Netanyahu said the only circumstances wherein Israel might miss the spending commitments were related to extraordinary costs associated with a Gaza withdrawal or an emergency plan to revamp Israel's education system. The draft LGA terms sheet outlines new planned reforms, including restructuring Israel's financial sector, ports and electricity markets, as well as continued privatization efforts. It also stresses the importance of intellectual property protection and notes the need to resolve procurement problems affecting U.S. companies doing business in Israel. Other issues discussed at the JEDG and in related meetings with GOI officials included:
-- the "Land Bridge" between Eilat and the Mediterranean, which Netanyahu said would cost $500 million and provide an alternative to the Suez Canal for cargo shipping. (Note: Netanyahu did not ask for U.S. financial support and none was offered by the U.S. side);
-- an update on Israel's improved growth prospects and pension reforms;
-- a U.S. call for heightened GOI steps to improve the Palestinian economy;
-- Israel's request for U.S. support regarding OECD accession, an issue which U/S Larson said involved reform of the organization's organizational structure as a prerequisite;
-- a review of Bank of Israel (BOI) monetary policy by Governor Klein;
-- a U.S. call for cooperation between the BOI and the Palestinian Monetary Authority, which Klein said he welcomed.
End summary.

Meeting with Finance Minister
Netanyahu - Expenditures and Tax Cuts

¶3. (C) In a small-group meeting to kick-off the JEDG on February 23, Netanyahu reviewed the main goals of Israel's economic plan:

--freezing government expenditures;

--using excess revenues to lower taxes and the deficit;

--moving from welfare to work;

--stimulating exports;

--breaking monopolies; and

--building infrastructure.

The Minister said his recent decision to cut Israel's value-added tax from 18% to 17% and reduce purchase taxes on

consumer durables was meant to help Israel's poor, since most of the economic reform program was "skewed to the top" (i.e., tended to benefit middle and upper income Israelis). This move, he said, was also consistent with his desire to cut both taxes and government spending and was affordable in light of expectations that 2004 revenues would come in above previous estimates. Netanyahu said he hoped to devote about half of any such excess revenue to deficit reduction and about half to tax cuts. Netanyahu said Israel would definitely keep to its 2004 expenditure commitment of NIS 226 billion, as it had in 2003, as well as to a budget deficit target of 4%. Exceptions to this policy would be allowed only if major, exceptional events forced the GOI's hands. Such events might include withdrawal from Gaza, unforeseen defense needs, and/or a major restructuring of Israel's education system, an issue currently being discussed in the government. This reform would result in lay-offs of many under-performing teachers and would costs hundreds of millions of shekels, he said. U/S Larson noted that, in view of these potential expenditures, the GOI might be well-advised to dedicate a higher portion of unforeseen tax revenues to deficit reduction. Netanyahu took this suggestion on board. Turning briefly to economic prospects, the Minister noted that world growth was likely to boost Israel's export-led recovery. He specifically mentioned the BOI's interest rate reduction policy as likely to promote economic growth.

Structural Reform Goals

¶4. (C) Netanyahu said the government would focus on four structural reforms in the coming year:

--restructuring Israel's inefficient ports,

--increasing competition in the financial markets,

--real estate reform, and

--easing red-tape and regulations that impede economic development.

The port reform, said Netanyahu, would almost certainly lead to labor conflict - possibly as early as late February. But, he continued, "reform has to be done, no matter what the cost." He furthermore noted that "the measure of a minister is his ability to fight the unions." He said the GOI would sell the port of Eilat, and would allow the Haifa and Ashdod ports to compete with each other on price and service. The two latter ports, he explained, would each be a separate company, with 51% government-ownership and the remainder sold off to private investors. The Minister of Transportation, Avigdor Lieberman, is fully supportive of the effort, he said.

¶5. (C) Netanyahu said that MOF Director General Yossi Bachar would lead an effort to create more competition in the financial markets by increasing transparency, adding new financial instruments, and reducing the strangle hold on the banking sector held by Israel's two largest banks - Hapoalim and Leumi. He said the privatization of Discount Bank would be a big part of that effort. He welcomed foreign banks into Israel as a way to increase competition. Real estate reform will be very difficult to implement, given the power held by the Israel Lands Authority, but Netanyahu said he would try to make changes. The Minister characterized the current land system, wherein 93% of land is state-owned (long lease contracts), as combining the worst elements of Ottoman, British, and Israeli bureaucracies. He noted that there were currently three overlapping land planning systems - the local, regional and national planning boards. One of these three planning boards, he said, must be eliminated to cut back on red tape. In fact, unnecessary regulation in many areas has held the economy back: "we need to move to a culture of regulation by exception." To change the regulatory culture, he said, was one of his largest and most difficult challenges. The Minister said the GOI was looking at Britain's regulatory reform as a possible model for GOI action.

The Land Bridge

¶6. (C) Minister Netanyahu reviewed some of Israel's transportation initiatives, but focused on the proposed rail link between the Red Sea and the Mediterranean. He estimated the total cost of this "Land Bridge" at USD 500 million. A rail link between the center of the country and Eilat was "definitely going to happen," he said. This link would set the stage for creating a rail-based cargo link between Eilat and Israel's Mediterranean ports that would provide shippers an alternative (if much smaller capacity) route to that of the Suez Canal. Preliminary studies by a consulting firm looking into the project had determined, he said, that the

best port to serve as the Red Sea terminal would be Eilat, not Aqaba. Despite this surprising finding, Netanyahu said he continued to believe that Aqaba should be the terminus, because it was important to bring Jordan into the project and make it beneficial for the entire region. He mentioned several other projects which could be combined with the "land-bridge," including an amusement park and casinos on the Jordan-Israel border. Netanyahu said that no final decision had been made on the project, but that PM Sharon might discuss it with President Bush in his upcoming trip to Washington. (Note: As reftel notes, Embassy sources in the PMO discount the likelihood of the PM raising this issue in Washington.)

Business Issues

¶7. (C) Under Secretary Larson raised three business issues with Netanyahu, noting that he and Under Secretary Taylor had met with the representatives of U.S. firms just before their meeting with the minister. U/S Larson expressed concern that proprietary pharmaceutical data was not protected in Israel, that the bilateral agricultural agreement remains unsigned, and that U.S. firms often feel they are not given a fair shot at government and parastatal procurement. In reaction to the data issue, Netanyahu turned to his Director General and said "This data isn't protected? That's a dirty trick! We need to fix this." On agriculture, Larson stressed this issue had come to the attention of the Chairman of the House Ways and Means Committee, and that there was no reason it should take so long to conclude a reasonable agreement. The Minister promised to look into this and into procurement issues.

The JEDG

¶8. (C) The formal session of the JEDG covered Israel's economic growth prospects, budgetary issues, Israel and the OECD, and ways in which Israel could help the Palestinian economy. On the economy, the MoF's Research Director said that a number of factors are pointing in the direction of strengthened Israeli growth. These include the global economic recovery, which is absorbing increased quantities of Israeli exports; decreasing Israeli interest rates; and continued improvements in Israeli productivity. These factors have led the MoF to increase its predicted 2004 growth figure from 2.5% to 3% or more. The GOI was also taking steps to increase Israel's labor participation rate, through measures aimed at making work more attractive. In this regard, he expressed concern at suggestions aimed at increasing Palestinian employment in the Israeli economy. Although this was a laudable goal, employment in sectors such as construction came directly at the cost of Israeli employment. Rather, the GOI should focus its efforts on increasing Palestinian employment in tradable goods sectors, where the employment pie could grow and accommodate both increased Israeli and Palestinian participation.

¶9. (C) The budget discussion focused on establishing a mutually-acceptable definition of expenditures. Both Under Secretaries said the USG required a detailed explanation of

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the NIS 228 billion expenditure figure for 2003 referred to by Minister Netanyahu. MoF DG Bachar promised to provide whatever information the USG required. He furthermore confirmed that the GOI uses this number as the basis of its new budgetary legislation limiting expenditure growth to 2010 to 1% a year in real terms. (Note: In subsequent, staff-level meetings with GOI budget experts, the USG side outlined exactly what information it required for reference in the terms sheet and received a promise that this information would be provided promptly. End Note.)

¶10. (C) The GOI officials also outlined pension reform and privatization programs. On pension reform, the Commissioner of Capital Markets, Insurance and Savings, Eyal Ben-Chlouch, highlighted the increase in the retirement age, contributions, and the amount of funds to be directed to the capital markets. The Director of the Israel Government Companies Authority, Eyal Gabbai, outlined achievements in privatization including the successful El Al IPO, the sale of majority ownership in Bezeq (telephones) and Zim (shipping), and the plan to introduce more competition in the electricity sector. There was also a brief discussion of monetary policy by the Bank of Israel's Deputy Governor, in which the current low-inflation environment and recent reductions in both short and long-term interest rates were highlighted.

¶11. (C) During a JEDG lunch hosted by Finance Ministry Minister without Portfolio Meir Sheetrit, Under Secretaries Larson and Taylor noted GOI efforts to improve Palestinian economic conditions and urged it to do more. Under Secretary Larson noted the importance of the GOI continuing its

transfers of Palestinian tax revenues to the PA, as well as addressing the issue of revenue attachments. Under Secretary Taylor cited the importance of reducing impediments to the free movement of goods and people within the West Bank and Gaza. Both officials noted they had pushed PA officials hard to improve performance in fighting terror, but also urged the GOI to think about constructive ways it could respond to positive PA moves should such occur. Sheetrit did not respond directly to these concerns, but rather stressed ways in which the Palestinians had undermined the peace process. He expressed his strong personal opposition to PM Sharon's ideas on unilateral disengagement, noting the issue could break up the coalition while bringing little or no improvement in security. In response to Sheetrit's statement that the best solution would be to "kill Yassir Arafat," Under Secretary Larson pushed back strongly, noting there was no way Israel could predict the consequences such an act could have. Sheetrit said he recognized Israel could take no steps against Arafat.

¶12. (C) Sheetrit urged the U.S. to support Israeli accession to the OECD. Under Secretary Larson said the U.S. wanted to enhance Israel's relationship with the OECD, but noted the complicated state-of-play on OECD enlargement. Before the organization increased its size, it was essential it implement extensive institutional reform aimed at streamlined decision making. He also noted that the composition of the next enlargement required extensive groundwork aimed at assuring regional balance in the organization. In the meantime, he urged the GOI to continue its efforts to work in whatever ways possible with OECD bodies.

¶13. (U) JEDG Participants:

U.S.
Alan Larson, Under Secretary of State for Economic, Business and Agricultural Affairs
John Taylor, Under Secretary of Treasury for International Affairs
Daniel Kurtzer, Ambassador
Theodore Mann, Economic Counselor (Notetaker)
Adnan Kifayat, Director, National Security Council
Dayna Cade, Special Assistant to Alan Larson
Tom Engle, Deputy Director, EB Office of Monetary Affairs
David Greene, NEA Office of Israel and Palestinian Affairs
Catherine Downard, Office of Near Eastern Affairs, Department of Treasury
Clark Price, Deputy Economic Counselor (Notetaker)

Israel
Benjamin Netanyahu, Minister of Finance
Meir Sheetrit, Minister in the Ministry of Finance
Joseph Bachar, Director General, MOF
Yaron Zelekha, Accountant General, MOF
Eyal Gabbai, Director Israel Government Companies Authority, MOF
Eyal Ben-Chlouch, Commissioner, Capital Market, Insurance and Saving, MOF
Michael Sarel, Head of Economics and Research Department, MOF
Dan Catarivas, Deputy Director General, International Affairs
Elded Fresher, Senior Deputy Accountant General, MOF
Boaz Raday, Economic Minister to Washington
Rani Loebenstein, Senior Advisor to the Director General, MOF
Yossi Gordon, Deputy Director, Budget Department, MOF
Meir Sokoler, Deputy Governor, Bank of Israel
Michel Strawczynski, Assistant Director, Research Department, Bank of Israel

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BOI Governor Klein Gives Netanyahu A Passing Grade

¶14. (C) In a meeting held after the conclusion of the JEDG, Bank of Israel Governor Klein reviewed GOI fiscal and monetary policy with U/S Larson and U/S Taylor. He said that the Bank had been able to bring down short-term rates relatively quickly - from 9.1% in the beginning of 2003 to 4.5% a year later - without igniting inflation. Markets had responded very positively, he said, to the fiscal restraint shown by the GOI, and long-term rates had also dropped. Finance Minister Netanyahu, he said, had convinced the markets that he is serious about economic reform, no small achievement. Klein expressed skepticism, however, about the government's ability to hold to a 1% per year expenditure increase until 2010, as stated in the JEDG. Such a commitment, which would require cuts in per capita spending every year, will be very hard to keep, he said. Klein also said that cutting taxes was no substitute for keeping spending in check. It is sometimes stated that the best way to control spending is to cut taxes (and so make less money available to the government). That is not true in Israel, he emphasized. Strict spending commitments are the only way to keep budgets under control.

¶15. (C) The government's newfound fiscal responsibility, continued Klein, remains constantly under pressure. He

recounted a recent conversation with the Minister of Health (Danny Naveh), in which the minister asked him how could it be that acceding to a NIS 500 million increase the ministry was asking for would really threaten the Israeli economy. Klein responded by saying that the notion that "small deviations" were acceptable was precisely how Israel's public sector grew to be "the largest in the world." Markets, continued Klein, were a little nervous about the Bank of Israel's willingness to continue reducing interest rates in light of spending pressures. In fact, long-term rates had risen in recent weeks, a sign that the markets are unsure the Bank will keep reducing short-term rates. Klein made it clear, however, that he believed there was still some room for further rate cuts while keeping within the 1-3% inflation target for 2004. He noted that rate would be cut later on February 23 (BOI cut the interest rate by 0.2% to 4.3%). Klein said that BOI's rates, after the pending cut, would be very close to rates in some European countries and noted that interest rates in the UK were at 4%.

Central Bank Regional Cooperation

¶16. (C) Klein said the recent meeting of central bankers from the Mediterranean region in Naples was unprecedented. He noted that he had talked to the central bank governors of Morocco, Egypt, Libya and the PA, among others, during the meetings. Klein said there was plenty of issues of common interest to talk about in meetings like this, no matter what the political differences between the countries represented. Possible topics might include, he said, central bank independence, and the various stages of capital market development. In response to a question from U/S Taylor, Klein said he would be happy to work with Amin Haddad, Governor of the Palestinian Monetary Authority, to help further cooperation on terrorist financing. This was an issue, he said, that he and Haddad had discussed in Naples.

Comment and Next Steps

¶17. (C) This JEDG accomplished a number of important goals. It recognized Minister Netanyahu's and the GOI's significant progress on economic reform over the past year while urging continued fiscal restraint, and did so both in private and in a number of press appearances. The meeting also underlined the close attention the USG is paying to the GOI's budget and how it is calculated. The draft 2004 terms sheet incorporates the issue of restraining GOI expenditures and meeting its deficit target for 2004.

¶18. (C) According to our MoF contacts, Minister Netanyahu is now reviewing the terms sheet draft and will respond to it as soon as possible.

Draft 2004 Terms Sheet

¶19. (C) Modifications to and Determinations of Specific Reforms Details in Annex II of the Loan Guarantee Commitment Agreement

The Joint Economic Development Group (JEDG), as the joint consultative mechanism referred to in Section 5.03 of the Loan Guarantee Commitment Agreement, and proceeding under Section 4.02 of the Loan Guarantee Commitment Agreement, determines and modifies the &specific reforms8 referred to in Section 4.02 by appending the following as Appendix 4 of Annex II.

CONDITIONS FOR DISBURSEMENT OF THE SECOND TRANCHE OF SUPPLEMENTAL ASSISTANCE

The second tranche of bond guarantees in the amount of up to $3.0 billion will be released on determination of completion of the following:

¶1. Progress on Reform Plan: Progress on the main measures of the GOI economic reform plan. This plan includes, among other things, reforms related to:
-- Acceleration of tax reform: Continued progress on final implementation of tax reforms (legislated in the Knesset in 2002) by January, 2006;
-- Pension Reform: Continued long-term reduction in issuance of special government bonds for pension funds;
-- Wage reforms: Continued reduction of public sector's budgetary expense on the wage bill as a percentage of GDP, to be achieved by cutting wages and/or benefits and/or reducing public sector employees.

¶2. Meet Spending and Budget Deficit Targets
-- Commit to expenditures (defined in Appendix X) in 2004 of no more than 226.1 billion New Israeli Shekels, with the firm goal of keeping the budget deficit to 4.0 percent of GDP or less.

-- Public dissemination and GOI commitment to a detailed, multi-year fiscal plan, including a commitment to limit real expenditure growth (defined in Appendix X) to 1 percent per year from 2005 to 2010. Furthermore, commitment to maintain budget deficits to a level of less than 3 percent of GDP and aim to implement further reductions in the operational deficit of at least 0.5 percent of GDP every year until the deficit reaches 1 percent of GDP.

-- Any revenues in excess of those foreseen in the 2004 budget would be allocated to deficit and tax reduction. Due emphasis should be given to deficit reduction.

¶3. Proceed with Privatization Plan
-- Further progress on the main measures of the Israeli government's privatization plan. Future privatization steps should focus on the twin goals of increasing competition as well as reducing government involvement in the economy.

¶4. Implement Structural Reforms
-- Increase competition in the economy by:
¶A. Implementing liberalization of the domestic telecommunications market through a regulatory environment that facilitates the introduction of competitive local landline services within the timeframe of this agreement;
¶B. Working to increase competition within the ports, financial markets, and electricity sectors;
¶C. Reduce governmental regulation with the aim of promoting economic growth.
-- Continue efforts to further strengthen IPR protection in Israel.

¶5. Undertake Infrastructure Investments
-- Commitment to, and progress on $1 billion in infrastructure spending as discussed in the GOI,s economic reform plan.

¶6. Other
-- The amount of guarantees that may be issued shall be reduced by an amount equal to the amount extended or estimated to have been extended by the GOI during the period from the last deduction to the date of issue of the 2004 guarantee, for activities which the President determines are inconsistent with the objectives and understandings reached between the United States and the Government of Israel regarding implementation of the loan guarantee program.
-- Commit to working with the U.S. Government to resolve outstanding procurement issues.
SUBSEQUENT DISBURSEMENTS

Subsequent disbursements of bond guarantees will be conditioned upon determination and implementation of the GOI,s macroeconomic, structural and other targets developed through the USG-GOI joint consultative mechanism. Fiscal deficit targets and implementation of the reform plan will be the main foci. In particular, disbursements of the third tranche of bond guarantees will be conditioned on achievement of the spending and budget deficit targets for 2004 and 2005. The extent to which other commitments made for the 2004 disbursement are met will also be an important consideration.

¶20. (U) This message was cleared by Under Secretaries Larson and Taylor.

KURTZER